PREFATORY NOTE

These transcripts have been produced from the original raw transcripts in the FOMC Secretariat's files. The Secretariat has lightly edited the originals to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcripts were not fully edited for accuracy at the time they were produced because they were intended only as an aid to the Secretariat in preparing the records of the Committee's policy actions. The edited transcripts have not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

May 19, 1987

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, May 19, 1987, at 9:10 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Boehne
Mr. Boykin
Mr. Heller
Mr. Johnson
Mr. Keehn
Ms. Seger
Mr. Stern

Messrs. Black, Forrestal, and Parry, Alternate Members of the Federal Open Market Committee

Messrs. Guffey, Melzer, and Morris, Presidents of the Federal Reserve Banks of Kansas City, St. Louis, and Boston, respectively

Mr. Kohn, Secretary and Staff Adviser
Mr. Bernard, Assistant Secretary
Mrs. Loney, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Lang, Lindsey, Prell, Rolnick, Rosenblum, Scheld, Siegman, and Simpson, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account

Mr. Cross, Manager for Foreign Operations, System Open Market Account

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Office of Staff Director for Monetary and Financial Policy, Board of Governors

Mr. Hendricks, First Vice President, Federal Reserve Bank of Cleveland

Mr. Fousek, Executive Vice President, Federal Reserve Bank of New York

Messrs. J. Davis, T. Davis, Mmes. Munnell and Tshinkel, Senior Vice Presidents, Federal Reserve Banks of Cleveland, Kansas City, Boston, and Atlanta, respectively

Messrs. Beebe, Burger, and Cook, Vice Presidents, Federal Reserve Banks of San Francisco, St. Louis, and Richmond, respectively

Ms. Lovett, Assistant Vice President, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting
of May 19, 1987

CHAIRMAN VOLCKER. We'll proceed with approval of the minutes.

MS. SEGER. I'll move approval.

MR. JOHNSON. I'll second.

CHAIRMAN VOLCKER. Without objection. The Report of Examination of the System Open Market Account dated May 11, 1987 has been distributed to you. Any comments or questions? If not, I would entertain a motion for approval.

MR. JOHNSON. So moved.

MS. SEGER. Second.

CHAIRMAN VOLCKER. Without objection. Mr. Cross.

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any questions or comments?

MR. BOEHNE. I have a question, Mr. Chairman. What are your thoughts on the likelihood of additional stimulative actions, either fiscal or monetary, by the Japanese and/or the Germans?

CHAIRMAN VOLCKER. Oh, me! I thought you were talking to Mr. Cross.

MR. CROSS. He's looking at you.

CHAIRMAN VOLCKER. Very limited. I don't think either of them has the intention of doing anything, on their own initiative anyway, in monetary policy right now. Their discount rates are well below the market rates. They are both moving a little to lower their money market rates. I understand what's going on. It is going on [unintelligible]. On the fiscal side, of course, the Japanese said they would do something. They have had a bit of a political problem there getting the budget passed and all the rest. They have said that they will do something and will do something, I suspect. Whether it's going to be effective before fall, say, and just what it will be I think is questionable. For the Germans on the fiscal side, I think some of them, including some people at the Bundesbank, are quite worried about the business outlook. There was a lot of talk at the OECD meeting in Paris, and their representative there said well, of course, they would look over the situation again if things didn't develop in a favorable way in the next few months. When he got back home Mr. Stoltenberg said they have no intention of changing anything and they've done all that they can do. So, I don't think the talk in Paris was indicative of any reason to sit at the edge of the seat for any move on the fiscal side. I don't think it's terribly right but that's the--

MR. BOEHNE. Do you have any sense that any kind of unilateral action that we might take would have much influence on their thinking?

CHAIRMAN VOLCKER. I don't think it probably would make that much difference on the fiscal side. But maybe if all the other forces move in the direction of embarrassing--is that the right word?--the Bank of Japan or the Bundesbank--. I wouldn't expect either of them to make a deal right at the moment or to respond immediately if we took any action. I think it would improve the chances, but how much is beyond me. It pretty clearly would set up a situation where the next step was up to them; they would have to recognize that.

MS. SEGER. Doesn't fiscal policy in those countries react with a lag as it does here? If they don't even consider it and then maybe move in the fall, it seems to me that the kind of impact--

CHAIRMAN VOLCKER. I think that's correct. You're not talking about anything very relevant for 1987 at this point without a sudden massive change in mind by the Germans, which we don't expect. Even if the law permitted them to act quite quickly on taxes and the circumstances arose to [warrant] triggering it, they don't appear to have any desire to trigger it.

MR. PARRY. In Japan, it appears that what they're suggesting is mainly increased construction. And those kinds of projects take a long time. It isn't so much taxation.

CHAIRMAN VOLCKER. Well, they're going through this usual [routine]--it's almost an annual ritual now--of saying maybe we'll move the public works budget into the first part of the year and speed up construction and all that. I don't think that amounts to much.

MR. PARRY. Right.

MR. FORRESTAL. Are we having ongoing discussions with the Germans and the Japanese with respect to their economies or have we given up for the moment?

CHAIRMAN VOLCKER. Well, I don't know what you mean by ongoing discussions. We have a certain amount of conversation with them but I don't sit on the edge of my seat, as I indicated, expecting that these ongoing conversations are certainly going to result in spurring them to new activities. The Bundesbank itself is quite split about what they should do--about 50/50. There is a lot of worry within the Bundesbank about the economic outlook.

MR. GUFFEY. When you speak of Germany, do you include all of Europe or the major players?

CHAIRMAN VOLCKER. Well, I could say that Germany kind of [represents] the rest of Europe, frankly, except for the British who are outside the EMS. There the expansion is pretty good relative to other countries; it seems to be not a breakneck rate but a pretty good rate of expansion. Among the others, I think a lot of them would like to do more but they feel they can't so long as Germany sits there. They're worried about their exchange rate and so forth. I don't know if any economy in the rest of Europe is really growing; they're probably going backwards too. Am I wrong about that, Mr. Truman, in terms of the rate of growth slipping rather than the reverse?

MR. TRUMAN. You are right, sir.

CHAIRMAN VOLCKER. Except for the British?

MR. TRUMAN. Definitely, and Italy.

CHAIRMAN VOLCKER. The French [economy] slowed down quite a while ago.

MR. TRUMAN. Yes.

CHAIRMAN VOLCKER. So, it's not a very buoyant situation, wherever one looks. The last time I talked to he seemed quite worried about the outlook, even more worried than before. But he's been worried quite a lot [unintelligible]. It's a tone of voice; [he seems] more worried than he has been.

MR. JOHNSON. He said the last time we talked that they don't get excited there unless the unemployment rate rises. He said it hasn't really gone up in the face of this weakening growth. If it were to start to rise he would have more of a political problem. Without it, will take the position he has.

MR. MELZER. Sam, how do you reconcile this negative sentiment on the dollar with these very wide interest rate differentials that you mentioned? What is that saying here?

MR. CROSS. I think the interest rate differentials are probably having some impact, but it makes it more costly to recommend [the dollar]. People think: If the dollar is going to be lower next week than this week, then we're better off to wait. They have a pretty short focus on how long they make these investments for these days. If the dollar is going down, it's better to wait. There are a lot of people who think it's going down further and there are certainly not very many who think it's going to go up. So, there's not much danger of losing [by waiting].

MR. PARRY. But doesn't the differential itself indicate that people think it's going to go down?

MR. CROSS. The differential is partly because of what the markets have done. The Japanese long-term rates have declined quite substantially, and much of this is because money is going back into Japan.

CHAIRMAN VOLCKER. When you look at monetary policy in Japan in particular, these long-term rates have gone down primarily because of monetary policy--maybe because it has been relatively stricter. This one bond issue that people follow got down toward 2-1/2 percent to get this [unintelligible].

MR. CROSS. Close to 2-1/2 percent, [the] number 89 [bond].

CHAIRMAN VOLCKER. It has been a long time since we've seen a long-term bond rate at 2-1/2 percent any place.

MR. CROSS. The Japanese are really quite worried about their situation because of all the liquidity and the vast [unintelligible] or growth in the stock market where some stocks are selling at 250 times earnings and so forth.

CHAIRMAN VOLCKER. [Unintelligible.]

MR. KEEHN. Sam, given the magnitude of the intervention so far and the results, what is the appetite of the other central banks to continue with this kind of magnitude?

MR. CROSS. I don't think we're going to see this kind of level of dollar purchases for a continuing period; there's no question about that. The market certainly has that view. So there are going to have to be some policy moves or we're going to have to begin to see some results from policy moves already taken. We haven't seen any very good statistical numbers to show that the trajectories have shifted and that things are going in the right direction. We haven't seen very much other than these monetary policy developments; we haven't seen developments on the policy front to show that something is being done that's going to do it. It's certainly the attitude of the market that intervention isn't going to remain at these levels for a continuing period. It's either going down or we're going to see some more adjustment.

CHAIRMAN VOLCKER. Of course, when we raise the question about what they're doing on fiscal policy they raise that question with us, too. It's rather a symmetrical question. Are there any other comments? We need to ratify the transactions.

VICE CHAIRMAN CORRIGAN. Move it.

MS. SEGER. Second.

CHAIRMAN VOLCKER. Without objection. Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. They say that's enough. Comments or questions?

MR. MELZER. Peter, just in a technical sense--and I know that extraordinary things were going on in this recent period--if you had a spread of 125 basis points between the discount rate and the prevailing federal funds rate, does that provide enough of an incentive to borrow that it makes it more difficult to hit a particular borrowings target? And does that, therefore, perhaps introduce a little more volatility in open market operations? I know that in the most recent period, as you've described, there were some other things going on. I guess my question really runs to the spread on an ongoing basis.

MR. STERNLIGHT. It has been very hard day-to-day to predict what that spread is likely to be. We have such a mixture of expectational elements still in there. The high Treasury balance has receded as an operational factor; it's not entirely gone, but it has receded some. I think the fairly substantial anticipation that something may well happen on the discount rate--and that we are not too unhappy with funds in a 6-1/2 to 6-3/4 percent or even 6-7/8 percent range--contributes to the funds rate staying up there, even though in some pure theory sense, going back to earlier model relationships of what funds rate we'd expect with $400 million of borrowing, I would come out with something considerably lower than the recently prevailing rates. I would agree with what the Bluebook suggests of a tendency for the rate to drift back to, or below, the 6-1/2 percent level. One could even make a case for something like 6-1/4 percent on the funds rate with planned borrowings holding at $400 million.

MR. BLACK. Peter, something you said earlier suggested to me that if you were to get that drifting back of the funds rate you would expect to see the dollar weaken right much. Is that a fair reading of what you said?

MR. STERNLIGHT. If the funds rate drifted back to that, I think that would be cause for renewed pressure on the dollar, yes. Sam might want to comment on that, too.

MR. PARRY. On what you've said about the market's reaction so far, are you saying that the market is probably assuming that the borrowing target is higher than it is?

MR. STERNLIGHT. Yes. Most people I've heard comment on it would be thinking in the $500 to $600 million range for borrowing, though I've heard some talk about $400 to $600 million, and I've heard one who thought it was above $600 million. But most would put it in the $500 to $600 million range.

MR. JOHNSON. Do you think that's probably because borrowings have averaged about $700 million?

MR. STERNLIGHT. Well, yes. But, certainly, the period when it was $1.1 billion they realized was extraordinary and unusual; and the period just before that, when it was nearly $700 million, they tended to think was on the higher-than-intended side as well.

MR. JOHNSON. When borrowing actually turns out to be $600 or $700 million, I think they expect the policy to be there.

MR. BLACK. They think we've got alternative C instead of alternative B.

MR. JOHNSON. I think we've got alternative C.

MS. SEGER. "C?"

MR. BLACK. That's what Peter said, really, I think.

CHAIRMAN VOLCKER. Any other questions? We need to ratify those transactions.

MS. SEGER. I'll move it.

MR. ANGELL. Second.

CHAIRMAN VOLCKER. Without objection. Mr. Kichline.

MR. KICHLINE. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Questions?

MR. BOEHNE. Jim, do you have any sense beyond what we've seen in autos, for example, that domestic producers are responding to higher import prices not so much by trying to grab off a bigger market share but by raising their own prices? I've sensed some anecdotal evidence of that. I was wondering if you have any sense of the extent of that.

MR. KICHLINE. As you know, the auto case is one you can point to. Beyond that we don't have anything explicit. If you look at the producer price index for April, in fact, very little was happening there taking away energy and food and cars. Basically, we're talking about prices that seem to be moving up at about the same rate. It's something we've been looking for. We run across these comments about producers looking for every opportunity to increase their margins but, at this point, we don't really have any hard evidence in hand.

MR. BOEHNE. a medium-sized manufacturing company that does a fair amount of export business as well as domestic business in office supplies and recreational supplies, that sort of thing. complaining for a couple of years about how they just can't make price increases stick. But in recent months they've been able to make some of these price increases stick. And not alone.

MR. PARRY. Jim, your forecast for consumption is quite weak, particularly the nondurable and services components and I have a comment and a question. With regard to services, as I'm sure you know, there's a strong secular component for the growth of services. The growth rate that you have probably is the kind of growth rate that one sees in recession periods. To me, that's a bit surprising. I think I understand why this is occurring in terms of your forecast. I guess the decline in the value of the dollar causes the PCE deflator to go up, which hits real income and then slows the growth of consumption. What I'm not sure I see is this: Why doesn't that increase in the PCE deflator affect other prices as heavily? I don't think I see it in your inflation rate. I don't have these deflators, so I'm trying to--

MR. KICHLINE. If you look at the GNP deflator or the GNP fixed-weighted index you have the persistent effect of net exports being subtracted, which tends to depress those GNP measures. If you look at private domestic final purchases prices, the PCE fixed-weight measure or deflator picks up very directly all of these import prices that we're talking about rising at double-digit rates. So you're right: we have prices for personal consumption expenditures rising even in excess of 4 percent--4-1/4 to nearly 5 percent in 1988. And that has the effect in this forecast of depressing real income growth. So you have it right in the sense of why we believe we will be facing a fairly weak picture on domestic consumption. I view it as part of the adjustment process and rising import prices depressing [consumption].

MR. PARRY. Would you say, looking at the risks in the consumption area, that they might be on the high side? Well, not durables.

MR. KICHLINE. Well, given everything, I'd say these consumption numbers outside of durables are at really very low growth rates. One might expect to find those rates happening in a recession environment. So in that sense consumption might be higher. On the other hand, we're starting with inflation picking up and the depressing effects of real income growth and other characteristics that I think would act to damp demand. You're quite correct; these are low rates of consumption.

MR. STERN. Jim, with regard to domestic auto sales, especially in the next couple of quarters, are you assuming anything in particular about incentive programs or anything that accounts for the strengthening you have here?

MR. KICHLINE. Explicitly, we've assumed that in order to reduce the stocks on hand, which are running at something like 75 days' supply, they will have to maintain incentives of one fashion or another. As we get into the third quarter, we have assumed a further cutback in domestic auto production and probably somewhat limited sales incentive programs to continue to sell those cars. So, I think it's a combination of incentives as well as some further cuts in production.

MR. MELZER. Jim, what is your assessment of the inventory situation other than autos?

MR. KICHLINE. Autos are the only area where we sense that there's a problem lurking. The data lag, and at times they're hard to interpret. In the manufacturing sector, certainly, for a long period of time manufacturers have been running with very low inventories. In fact, in this forecast the inventory/sales ratios are flat or drifting down. So we haven't spotted any sectors where unusual things are going on outside of autos.

MS. SEGER. Jim, do you really think that the producers of durable equipment will snap back after only one quarter of weakness? Isn't the tax reform impact going to, unfortunately, last longer?

MR. KICHLINE. This is, in part, the arithmetic. January just plunged and plunged partly because included in business investment would be auto and light truck purchases. So part of the arithmetic is that as February and March came back, orders sort of flattened out. We know auto sales were rising a bit, and so for the second quarter, instead of the 13 percent drop recorded in the first quarter, we have a pickup in real terms to something like 6-1/4 percent. In part that's arithmetic; in part that's a pickup in auto sales. But I think one ought to read through that; and when we read through it we have essentially unchanged business spending for the year in real terms. I think that's a more accurate picture.

MS. SEGER. Thank you.

MR. PARRY. Compensation per manhour, which I'm sure is the key element of your inflation forecast, seems to change dramatically in 1988. Why is there such a change so abruptly? I'm not questioning that it's going to rise. It just seems to be going at one level, and you have a step function, and then it stays at that [higher] level.

MR. KICHLINE. There are a number of things going on. To begin with, in January 1988 there is a sizable increase in Social Security taxes and, along with that, an assumed further rise in the wage base. We've assumed that compensation will kick up by 4/10ths of 1 percent beginning QI '88 because of the large Social Security tax increase--the employer share. Other features are that we assume that we're going to begin to have a more forceful effect of higher prices feeding back into wage behavior in 1988. In this forecast, as you may have noticed, we have a lower path for the unemployment rate. We were caught by surprise by the numbers that have come out. We think there might be a little problem there. Essentially, in the forecast, we're going to be looking at an unemployment rate of 6-1/4 percent later on in 1988. Who knows what the natural rate is, but we think that we're probably in a range somewhere pretty close to that. So we're not going to have a damping effect on wage growth that we had previously.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I'd just like to make a comment on business conditions generally. In our District, I think the economy has performed better so far this year than most people expected. Unemployment for the region, for example, is under 5 percent. States like New Jersey and Delaware are in the 3 percent range and even areas of Pennsylvania are doing fairly well. Strength continues in construction, both residential and nonresidential; the retailers are generally upbeat; loan growth in all categories continues to be above the national average. In manufacturing, I would say that the erosion of jobs in manufacturing areas has tended to cease and there is a modest comeback. So, I think the manufacturing [sentiment] has shifted from a negative attitude to one that's somewhat positive, although I must say I was with a couple hundred manufacturers last week and they still like protectionism and they don't like higher interest rates, or snugging up, or whatever we call it.

Turning to the national scene, it seems to me that while our forecasts are generally on target, if anything, the economy is turning out to be a touch better. In the trade area, at least I feel better--not so much because we're exceeding expectations but because some evidence supporting the forecast of a turnaround, while not dramatic, seems to be there. There is some positive evidence that exports are improving and that we can expect some strength in that area. However, I think the real news on the national scene is what's happening to inflation. It's not so much that the indicators of inflation are going up; I think we expected that in terms of energy and import prices. What is of concern--and we see it in financial markets, but we also hear it in just talking to business people generally--is a heightened concern about the future course of inflation. I think it really comes down to some doubt about whether we can keep these adjustments to be one-time adjustments or whether we're about to set off a new upward trend in inflation. I think that is the real change in the last six weeks to two months--that concern about inflation is significantly higher than it was the last time we met.

MR. JOHNSON. Are we going around the table now? I wanted to ask Jim something before we did that.

CHAIRMAN VOLCKER. You can insert a question.

MR. JOHNSON. Okay. The Board had a briefing yesterday on the Greenbook material. I'm going to ask you to go through the points about employment and the full employment unemployment rate. I think it's important that you try to reconcile again for everybody here this whole issue between industrial production and capacity and the unemployment numbers and work hours. The statistics don't tell the same story. And I've never gotten a really satisfactory explanation of which one makes the most sense.

MR. KICHLINE. I don't think you're going to get one now either! It is curious that we are seeing what is really a fairly sluggish industrial sector, particularly for the last couple of months. We can explain the autos and trucks, and that's the bulk of the decline. But in the detail in the industrial production index, as I noted yesterday, in many of the sectors where we thought we'd see some rise because of export orders growing nothing is happening. There have been really widespread weaknesses for two months. We have some difficulty reconciling that, obviously, with total payroll employment, which gives the picture of a lot of spending. Virtually all of that is in the trade and services areas; it's not really spilling over into manufacturing. One of the concerns in the forecast is that we have built in, frankly even for the current quarter, increases of 0.3 to 0.4 percent in industrial production in May and June, which we think needs to occur to rationalize what has been happening. We have a month or two divergence between these various signals. We also have, as you know, the problem--

CHAIRMAN VOLCKER. You have how big of an increase?

MR. KICHLINE. We have about 0.4 percent per month in May and June. We think that would be consistent; it sort of reconciles the problem that Governor Johnson was raising that the industrial sector looks very sluggish. Whether or not that materializes is, for now, an open question. I can't really do a lot more than to say we do--

MR. JOHNSON. No, I just wanted that repeated because it is confusing in that we have a situation where the unemployment rate is projected to get down to very low levels and yet we're still at close to record levels of excess capacity and low industrial production. I tend to believe the employment numbers a little more, but I don't know exactly how to reconcile them either. I'm just saying that's a dilemma I think everybody ought to know about.

MR. PARRY. Well, I'm not sure that they're completely inconsistent. Almost all the increase that we've seen in the employment area has been in the services area, outside of manufacturing. As far as policy is concerned, the question is whether or not relatively full employment of labor resources could lead to demand pressures. That could occur in the services area and I wouldn't--

MR. JOHNSON. Yes, I know; there's no doubt about that. But given the way the forecast is shaped, we've got a situation where there is low growth in the services area, which you already acknowledged, Bob, and a shift to trade-related, industrial-related, types of functions. It's not showing up in the numbers even though we are feeling better about it. Bob has just said he's feeling better about it, and I'm feeling better about it. It's just not in the numbers. And if there is going to be that re-composition, one would expect to see it in industrial production.

MR. MORRIS. Wait a minute. Are you talking [unintelligible] the workweek number of--

VICE CHAIRMAN CORRIGAN. There is nothing wrong with weak industrial capacity where we need it.

MR. JOHNSON. Yes, I--

VICE CHAIRMAN CORRIGAN. Take autos as the classic case in point.

MS. SEGER. The autos don't have [a] capacity [problem]?

VICE CHAIRMAN CORRIGAN. Yes. They don't.

MR. KICHLINE. Let me note that the 0.4 and 0.3 percent--pick whichever month you want that in--but we're stuck with minus 0.4 percent in April. On a quarterly average basis, that pickup will give zero growth in industrial output in the second quarter. We have 2-1/2 percent growth at an annual rate in the first quarter, but we need a pickup even to get zero, given that we are starting out at a low number.

MR. PARRY. Is that excluding autos?

MR. BLACK. It's still down; everything--

MR. KICHLINE. Autos and trucks, for example, were worth almost 3/10ths of the 4/10ths decline, so 2/3 to 3/4 of the depressing factor came out of the motor vehicles sector. President Morris, you asked about the workweek. You're quite correct: the numbers in the workweek were depressed because there were religious holidays during that week. For manufacturing production hours, they're down something like 1 percent. Looking at the path over the last 20 years, in the few years in which this has occurred virtually 3/5ths to 2/3rds of that is alleged by our folks who do this to have been accounted for by the effect of the holidays. So, a lot of that has been discounted in putting together the industrial production data.

MR. FORRESTAL. Jim, I wanted to raise a question about commodity prices. Obviously, they shot up in the most recent month. Are there any special factors that would account for that or do you think it's a more permanent type of adjustment?

MR. KICHLINE. Well, there are lots of special factors. It depends on which market. On the CRB futures, Don was reporting on Friday that before it rained it was the dry Midwest; and then the rains came in the Midwest and prices plummeted. So part of it, I think, is just heightened expectations in looking for anything [as a reason]. Some of the livestock prices, we think, reflect the late winter weather and the snowstorms in the Midwest. In lead and zinc markets, we've looked at Canadian strikes. When you go through all of it, you can look at special factors. The fact is simply that the markets have been very sensitized to inflationary expectations and sort of look for an opportunity to drive prices up. But there are lots of special factors, and perhaps some reactions have been very much overdone. It's clear to me that it's just heightened sensitivity to inflation at work.

MR. GUFFEY. Do you call that speculation?

MR. KICHLINE. If you wish.

CHAIRMAN VOLCKER. Mr. Parry, you wanted to make more general comments, I hope.

MR. PARRY. Mr. Chairman, basically, I agree with the staff's forecast of real GNP for this year and next. The growth rates of 3 percent and 2-1/2 percent, respectively, certainly seem reasonable to me. I also would agree that the primary source of strength is likely to be an improved net export position. However, as would be indicated from some of our discussion, I would expect the improvement in this area to be somewhat less and the strength of consumption, particularly that of services, to be slightly greater. In the inflation area, I think a good case can be made for a 4 to 4-1/2 percent rate of inflation in the remaining quarters of this year, as compared to the staff's forecast of a gradual decline to a 3.2 percent rate in the fourth quarter of 1987. We have seen a large increase in the real price of oil, which could have significant effects on the inflation rate during the rest of this year. I think it's generally agreed--certainly in our forecast and the staff's forecast--that prices of non-oil imports are going to continue to rise in an area in excess of 10 percent. Moreover, the decline in the unemployment rate, I believe, takes us into the range of full employment of labor resources. And, finally, inflationary expectations seem to be more serious, judging from financial market developments for the last six weeks. As far as 1988's inflation rate is concerned, there is quite a pickup in the staff's forecast of the inflation rate. And I think the factors that I mentioned are likely to cause that to occur.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I come out pretty close to the Board staff's forecast. We are a tad stronger than they are and had been even stronger; but we moved more closely to them because of the weakness in consumption in the first quarter, even abstracting from the automobile situation. I agree with the point that Bob Parry just made that the balance of trade is going to be the strongest part of it. I think Ed Boehne really put his finger on what is a more important issue there, and that is the extent to which the general outlook at the moment is correctly reflecting the amount of inflation that we're going to have. There are a lot of inflationary expectations around the economy, as indicated by the bond markets. And there's some question in my mind as to whether that's justified. I think all of you know that I believe the primary objective of monetary policy is price stability; but based on what knowledge we now have about prices I think there's at least some chance that the markets have overstated the extent to which there's a risk of acceleration in price pressures. We're clearly experiencing a lot of increases in prices in the energy area and in food prices, both at the consumer and the producer price levels; and we've gotten scattered price increases because of depreciation of the dollar. But these are all relative price increases; they don't necessarily mean that we're going to see that much increase in the overall price level. Of course, we've had this strength to which many people have alluded in the commodity prices and in commodity futures. But, again, there's a lot of noise in these data; there are a lot of special factors and there is some question as to how accurate these are going to be in predicting what the overall price level is really going to do. I don't want you to misunderstand me; I'm not saying that I don't think there's any chance that we're going to have a pronounced rise in inflation. I just simply am not quite convinced yet that those fears, as expressed in the changing nature of the yield curve, are really quite justified at this point. The economy still looks sort of weak in spots, so we ought to think about it pretty cautiously. But this is the point at which I think we usually have made our errors in policy in the past, so it's something to which we want to give a great deal of attention.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, with respect to the staff forecast, in principle, I pretty much go along with it, although it's hard to be looking at it from the perspective of our District, which causes me to think that, if anything, it might be a little on the high side. But it's probably about right. On the inflation issue, I do share the concern that has been expressed by the staff, particularly in the Greenbook, about the rise in inflationary trends. I'm especially worried about that if it should translate into wage pressures next year.

Our Eleventh District economy would be characterized as being flat and stable at a pretty low level, certainly for us. If the U.S. economy can maintain the 2-1/2 to 3 percent growth, I think that we have some possibilities or potential for our District. A few of the sectors that have been performing poorly have begun to show a little sign of improvement. Of course, what's happening to energy prices has caused a bit of encouragement, although to get a great amount of recovery there I think prices of oil are going to have to go higher. In agriculture, we think the financial strains are not quite as great as they were; certainly, the livestock prices and cotton look pretty good. We do think that we're probably seeing now the bottom of the decline in land prices, both in ranching and agriculture. In manufacturing, we're seeing some signs of general improvement with defense and electronics leading the way there. In real estate, I think we're seeing a little change in psychology as opposed to any real change in substance. Most people involved in real estate are saying that by year-end we will see rental prices and rental rates starting to move back up and some improvement in the price of land. We had a very real psychological impact with JC Penney moving out of New York to Dallas. For some reason, that seems to have convinced everybody in the metroplex that our worries are over now. I think there has been a bit too much euphoria regarding the interest of companies in moving to Houston and Dallas because of attractive real estate properties and other incentives that are there. Of course, we have had the sharp drop off in construction; we're feeling that.

Banking conditions continue to deteriorate. We're leading, certainly, in bank closings. In Texas so far there have been about 27 and we're looking for maybe 3 or 4 this week. We don't see very much slowdown on that, although our new branching law in Texas has certainly made it much easier to find potential buyers and resolve these problems. On the whole, we don't have a lot of cause for optimism, but certainly, we think the economic conditions are no longer deteriorating in our part of the world.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Thank you, Mr. Chairman. With regard to the national economy, it seems to me that, at least on the real side, so far things are unfolding about as we expected. The first quarter growth was in inventories and in net exports, and I think that was largely anticipated. Some of the weakness in other components seemed to be due to changes in tax laws that accelerated expenditures in the fourth quarter--in auto sales and so forth. So, it seems to me that, basically, we're on course and the Greenbook forecast is certainly in the ballpark. If there has been any surprise, to me it has been the real strength in employment. If you go back over the last 4, 6, 8 months, the increase in jobs has been running at about a 3 million pace, at an annual rate. Even if the base is somewhat sensitive to when strikes did and didn't occur, there certainly seems to be no evidence to date of any slowing in employment growth relative to the last couple of years, to put it cautiously. One surprise that has occurred is in states in our District where I think it's true universally that both the fourth quarter of last year and the first quarter of this year were better than we had expected and better than most other analysts out our way had expected. Good weather may have had something to do with that; it's hard to know how to quantify that. Certainly, the employment gains and the income gains in our states in both the fourth and first quarters surpassed expectations.

With regard to commodity prices, I did have a chance to talk to some of the people at the grain trading firms in the Twin Cities the last several days and I got a two-part explanation. Part of the explanation with regard to agricultural commodities was based on weather concerns here and abroad, coupled with the acreage set-aside program and the idea that this was the first time in several years where, because of those concerns, purchasers wanted to lock things in. But the second explanation I got was simply that commodity prices are low and the dollar is low--kind of an inflationary-expectations view that they were about to go up, or at least they didn't seem likely to go much lower. Frankly, I think it's the phenomenon we're seeing in the bond market as well. It's clear, or at least I think it's clear, that you can't explain what has happened to commodity prices with any real phenomenon today. It has to be largely expectations.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Our outlook for the economy is certainly consistent with the staff's forecast. As we look at developments in our District the situation really does continue to improve, and I think the general outlook is certainly more positive. Auto production is an exception; Jim Kichline has already commented on that. But I would say that maybe we have a slight difference on the truck side of the automotive business. From the people I've talked to in Detroit, they would anticipate a slight increase in their production schedule for trucks, both in the second and third quarters. The steel business has been surprisingly good, better than we would have expected. Some of the sheet steel producers are operating pretty much at capacity, with a lot of that going into appliances. Also, the demand for some categories of steel that in the past has been very slow is beginning to pick up. I am somewhat surprised, for example, that steel going into gas pipelines is improving, and even steel for railroad equipment is higher than it has been. Construction activity continues to be very strong. I never cease to be amazed, but commercial buildings in Chicago are continuing to be started and to go under construction. Residential construction has been very high in our District. Home starts this year so far have been significantly higher than the national average. As a consequence, the demand for building products has been strong. For example, they've produced gypsum in the first quarter at an absolutely record level.

On the agricultural side, I'd confirm what Bob Boykin has just said. It seems to us that the land values really are beginning to stabilize. Our first-quarter survey indicated some stability there for the first time in a long time, and though one quarter doesn't a trend make, nonetheless it is certainly an improvement. Of course, the commodity prices--the increases for both corn and soybeans recently--have been a very significant help relating to land values. This has not gone through to the tractor and implement manufacturers where the situation continues to be very, very tough. Dealer inventories are low. There's a lot of floor traffic, I'm told, but very few sales. The farmers are reducing their debt; it certainly is a good thing that they're reducing their debt just as fast as they can. And, therefore, they're not in a position to take on new obligations for equipment. But it's possible that the agricultural situation is stabilizing, admittedly at a low level, and that it won't continue to decline.

I must say that I find the inflation issue very, very perplexing. Absolutely everybody is talking about it and worrying about it, and I think that in itself can be a little self-fulfilling. [It's not in] the numbers we look at, as we have commented. Outside of the food and the energy sectors, I can find very few people who are talking about price increases that seem to be out of line. There are a wholesale series of price increases of the 2 or 3 percent category; those seem to be the norm. I guess the difference is that this time last year, and really until very recently, we were talking about price decreases; now we're talking about price increases of 2 to 3 percent. I think there's a very important shift in the psychology that goes along with that change of going from decreases to increases. Certainly, long-term rates are telling us something. They're either saying we're going to get very, very strong economic growth or the rate of inflation is going to pick up. And, related to Bob Black's comment, I think that it is perhaps appropriate that we take some steps to try and reassure the markets with regard to our commitment to price stability.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Let me say a brief word or two about the region first. Conditions in the Southeast are pretty much the same as I've been reporting over the past couple of months, with weakness in the energy states continuing and generally favorable outlooks for most of the other states in the District. Even in the stronger states, very little pressure is being reported on wages. Tennessee is a little different. That state has been pretty much functioning at the national average but we're now beginning to see some softness since many of the industries there are geared to consumer durables, which have been pretty weak. Many, of course, are suppliers to housing as well as to the auto sector. And, I guess symptomatic of what's going on in the automobile industry, there is a scaling down of GM's highly-touted Saturn plants near Nashville. Together with that, we've seen some unwinding of the speculative increases in the land prices surrounding that plant. Another interesting phenomenon is in the textile industry, which had been complaining bitterly about imports and crying for a long time for protectionist measures. They are continuing to report very good demand, high levels of activity, and record earnings in many plants. Maybe this is an example we can point to of how more efficient management, automation, and cost cutting can pull an industry that is dealing with import problems out of their problems without protectionist legislation. As others have reported, farm values are stable now and moving somewhat higher in some parts of the District due to the generally better agricultural outlook and partly to stronger economies in the area. In general, I think the outlook in the region is a little more favorable than it had been--outside of Louisiana, which continues to suffer from the energy-related problems. But even there, there is some feeling that things may be beginning to turn around.

Inflation is clearly the number one topic of conversation among people I talk to. Interestingly, though, while they're talking about inflation and their fear of inflation, some of my directors are also reporting that they're unable to get any price increases. They report that as soon as they try to get a price increase, the customer puts the [proposal] out for bids. Very often, those bids are accepted at a lower level, so they have to run back and get the customer booked on the lower price.

With respect to the national economy, our outlook is pretty much the same as it has been for some time. I had been concerned about the downside risks in the economy; I still have some of that concern but I guess it has diminished a little since the economy looks just a tad better than it had been. On balance, I think we're quite close to the Greenbook forecast although we, like some others, would expect higher inflation in the latter part of the year rather than a tapering off as the Greenbook suggests. All things considered, it seems to me that the outlook is generally favorable for the economy and I think we're doing about as well as we can. If we get 3 percent, we're probably going to be at about the potential for the economy. Although inflation clearly is a concern and I would share that concern, the big change I would note is that we've successively over the past couple of months lowered our expectations of growth in our trading partners abroad. And my major concern at the moment is that the world's economic performance is becoming increasingly dependent on our economy. Given the reluctance that was confirmed this morning of some of our trading partners to stimulate their economies, I think that we have the potential for risks globally. So, in terms of policy, I guess I'm willing to live with a little more inflation, if in fact that comes about, since it seems to me that the risks to the world from a significant slowdown in our economy are even more worrisome.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. As to the outlook on a national level, we're very close to the Greenbook forecast; I have no real quarrel with it. We're just a tad higher on inflation than the Greenbook, but beyond that, it seems to be a reasonable forecast.

With respect to the region, it seems to me that there has been a bit of a change in the outlook of participants in the business, agricultural, and energy sectors. It isn't clear to me why, because the numbers don't really reveal that things have turned up. What has occurred includes developments that have been mentioned around the table: for example, the stabilization, or the lack of further decline, in agricultural land prices; and a bit of greater activity in the energy sector, both in the petroleum and natural gas area. It may be that, as a result of having looked at a decline over roughly the last 3 to 4 years, when people don't see the decline continuing then that's cause for optimism. As a matter of fact, in the agricultural sector, for example--and the comments about the agricultural land prices stabilizing are revealed in our most recent survey as well--there have been some fairly sizable agricultural land sales, but they are generally led by the Federal Land Bank. And those are all induced by concessional interest rate arrangements. That is, they will sell but they'll finance at 2, 3, or 4 percent and, therefore, it makes it reasonable for some of the producers to pick up that land. When it comes to other land sales, we find they are largely to the farmer next door who wasn't caught in the debt burden situation and who simply believes that the agricultural land values at the moment are such that he wants to add to his other land holdings and can make the numbers work at these prices. I would say that this quarter was the first time in six years that agricultural land values have not continued the decline. And they're roughly now 55 percent of what they were in value in 1981. That is coupled with other things in the agricultural area--for example, the projection that the wheat crop that will be harvested starting now and into June and July will be something in the neighborhood of the sixth largest wheat crop ever produced, which means that the government agricultural policy is the one that is going to pick up and buy that grain unless exports pick up. There has been some euphoria, if you will, among those producers because of the Russian agricultural wheat and grain sale and export prospects. In the cattle/red meat market, they are still making money and that should continue.

With regard to the question of inflation, in talking with the agricultural and small business representatives, our Board of Directors, and other business people, I don't hear as much talk about price increases in our region as I've just heard around this table. As a matter of fact, I've heard of some price increases being put in place but not sticking; they are backing off from them. If we're concerned about inflation--which obviously we should be if our objective is price stability--it seems to me that the pressures are coming largely from food and energy and import prices. Those all should be one-time increases. As a result, unless one believes that inflationary expectations are going to be built into the wage levels, I don't believe we should be taking actions, at this point at least, to offset higher prices coming from those sources alone.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. I continue to be concerned about the sluggishness that I see in the economy. I thought the industrial production figures for April showed widespread weakness. Admittedly, it was concentrated in autos, but that certainly wasn't the whole story. Even the March figures showed some weakness beyond autos. I discussed this with Jim Kichline and I am wondering if we have enough weakness built into our figure for 1987 for the auto industry because, in my judgment, we haven't yet seen the impact of the recent runup in interest rates on most of these indicators since so much of it took place in April and so far in May. So, I am concerned that the forecast may be a bit high there.

Because I am interested in autos--and from the comments around the table some others may be too--I will share a couple of observations that I got from They are basically very disappointed in the auto sales figures in April and, particularly, in early May. At General Motors, they are using incentives selectively; generally, they have a combination of the rebates to consumers, the special deals on interest rates, and also some rebates that they are giving directly to the dealers themselves. For example, Cadillac will pay between $1000 and $2000 per car for every one that the dealer moves of certain slow-moving models. That's tremendous. Also, imports for the first time are not selling very well. The Japanese are not selling up to their quota, even with the incentives that they are offering. lost money in January and February; that's not a terribly good sign. Inventories, of course, are extremely heavy. The comment was that they have no more asphalt to put the cars on and now they are going to corn fields and wheat fields. Also, it was pointed out to me that the statistics that have been reported so far this year may, in fact, overstate the strength of the true retail demand because the fleet sales were concentrated in the first couple months of the year and they have been running 25 to 30 percent of the deliveries so far. Fleet sales do go through dealers and, therefore, are picked up in these numbers that we follow.

A couple of comments again, they are very disappointed with the pace of auto sales, particularly in April and early May. They point out that trucks also were showing some weakness. They think forty thousand more units will be removed from production schedules over the next three months because of the continued oversupply of new cars. They don't have the same attitude about dealing with their retailers as what to produce and then dumps them on the dealers. takes into account more what the dealers would like to receive. Also, is using a negative real GNP growth figure for this quarter, about minus 1-1/2 percent seasonally adjusted at an annual rate, mainly because there is no inventory buildup. They expect auto sales of 10 million units for 1987 versus 11.4 million last year. If they are right, of course, that's around 400,000 less, I believe, than what we are using.

But again, these are numbers that are being reviewed because of the recent uptick in interest rates. Across the board, there is a massive effort to hike sales because there are great economies to keeping the production lines running. Therefore, where it used to be that auto production was cyclical, now the production is more stabilized and profits are cyclical. A final point is--and this isn't a very good sign as I read it--that more and more people are taking the rebates, when offered, because they need it for the down payment. In other words, they are that marginally in the market. They are also going for the longer-term contracts in order to get a monthly payment that will fit into their budgets. So, those observations made me even more concerned about the fundamental strength of the economy.

In terms of what's happening on the inflation front, I think in a way maybe we ourselves are contributing to it because we talk so much about it. I think it's wrong to read every wriggle in the bond market as a sign of inflation or inflation psychology. Having worked with investments for 10 years, I can tell you a lot of people who trade bonds don't have anything in mind; they are just throwing pieces of paper around. To attribute great analysis to the move, I think, can really be a mistake.

CHAIRMAN VOLCKER. Mr. Hendricks.

MR. HENDRICKS. Thank you, Mr. Chairman. The mood in the Fourth District has improved. Some have said it has gone from lackluster to hopeful to reasonably satisfied. Much of the improvement seems to be due to the improving trade situation. According to our information, employment, orders, and output are expanding and labor costs of manufacturing continue to remain rather moderate. In a relative sense, I guess, we have not heard so much optimism around our board of directors table in quite some time. People in the metals industry tell us capacity is being used up here and abroad and that price increases are achievable in certain product lines. We are also told that the worst of the over-building in commercial construction may be behind us. With respect to agriculture, our lenders are anticipating a better year now than six months ago. Those who follow oil indicate that some oil company executives are even beginning to talk about the possibility of some drilling late in the year. This better mood is encouraging to us because it is consistent with what we feel the outlook is for the economy--generally moderate growth. And, we are pretty much in line with the Greenbook projections.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I would like to reinforce the comments of Bob Black and others who have argued that the inflation hysteria on Wall Street is greatly overdone. We have manicured the numbers and we cannot find in the numbers any increased inflation other than that which we would have expected from the agricultural and energy areas 6 or 9 months ago. If you look at the broad indexes, the producer price index excluding food and energy, for example, was up at a 2.2 percent rate in the past 6 months ending April. For the past 12 months, it was up 2.6 percent. I don't see yet in either the consumer price index or the producer price index any evidence of increased inflation outside the agricultural and energy sectors. That's not saying it may not be coming at some point. I don't see yet in the numbers any significant impact of the decline in the dollar in the aggregate price indexes.

MR. PARRY. Non-oil import prices were up over 10 percent over the last quarter. That's strong. That's one area.

MR. MORRIS. Pardon me?

MR. ANGELL. Non-oil import prices were up over 10 percent in the first quarter.

MR. MORRIS. That may well be, but I don't see it showing up in the broad indexes. What we are going to see, I think, is a decline in the volume of imported products and a lesser share of imports in retail sales.

MR. MELZER. Were you talking about the CPI? You mentioned some very low figures. I have some here--

MR. MORRIS. I was talking about the producer price index, excluding all food and fuel. I would expect it to show up there first if there is going to be an increase in prices on the part of our producers in response to the greater market opportunities stemming from higher import prices. I am not saying it may not be coming down the road, but it is not there yet. It just seems to me that the Wall Street hysteria primarily reflects the losses that bond dealers have taken in their bond portfolios; that was a function of the decline in the dollar rather than any real change in our inflation outlook.

On the manufacturing side, I have the sense that New England manufacturing is rising. It certainly is showing up again in my Boston airport numbers. The first-quarter export air freight shipments were up 35 percent and import air freight shipments were down 3 percent. This is the first quarter since the series began in the first quarter of 1984 where the physical volume of export air freight shipments exceeded the physical volume of import shipments. But what I don't see is any reflection in the employment numbers for manufacturing, which have flattened out; that has been essentially unchanged in New England since the middle of last year. That suggests to me that we are getting some pretty big gains in manufacturing productivity and that perhaps we are not going to see sizable gains in manufacturing employment but rather more sizable gains in productivity than we have seen. That is a tradeoff that I find quite acceptable, if that turns out to be the case.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. I can be relatively brief. I am about where Mr. Boehne was an hour ago. As a matter of fact, Mr. Boehne captured my assessment rather well. I think there are risks in the real economy, here and abroad, but basically the way things have unfolded so far this year is pretty much in line both with what was expected and, indeed, with what I think constitutes a fairly satisfactory performance, given where we are. I do think that there has been a change in the past six weeks on the inflation front, and I think it goes well beyond Wall Street. I think six, eight, ten weeks ago, there was a whiff of inflation--that was the phrase--and that may have been more concentrated on Wall Street. But at this point I think there is more to it than that. Si Keehn's comment puts it in very good perspective. If you have a sector of the economy where you had price decreases and now you have small increases, and everything else stays the same elsewhere in the economy, the cumulative weight on the inflation side is obviously greater. As I look at the indices, I certainly would agree that some of the forces working in the direction of higher measured rates of inflation were predictable--energy prices, and to some extent, agricultural prices, and certainly import prices. But even if they were predictable, it seems to me one of two things, or both, may be operative: first, that the amounts of those increases may be larger than most people thought they were going to be; and second--I am by no means saying that--that there isn't any such thing as one-time price increases. I think there is a tendency for these things to cumulate. So, whether it's in terms of forecasts--and not Wall Street forecasts, but forecasts from any number of sources around the country--or what is in the actual statistics themselves, I come away with the view that either actual or forecast rates of inflation have stepped up by something in the area of a half point and maybe even as much as a point. We are looking now at consumer price increases, excluding food and energy, probably on the up side of 4-1/2 percent. It doesn't take a lot to get to 5 percent; and once you get to 5 percent, I think the argument that it will wash out becomes that much more questionable. So, I think there is a change on the inflation side.

CHAIRMAN VOLCKER. We seem to have disagreements about some facts and analysis. What is going on in the consumer price index outside food and energy, Mr. Kichline?

MR. KICHLINE. Well, I don't have the monthly numbers, which may give a different pattern, but on a quarterly average basis for the first quarter all items less food and energy were up 4.4 percent at an annual rate; they were up 3.8 percent in the fourth quarter of 1986. When I mentioned non-petroleum import prices feeding through more visibly, in part our reading is in the CPI excluding food and energy, which we say is up 1/2 point or so in the recent numbers.

MR. MORRIS. But that index was at least that high in the first quarter of 1986.

MR. KICHLINE. Correct.

MR. PARRY. The other point is that the forecast has the rate--again excluding food and energy--at 5 percent and above for 1988; so it's not only that it has been running relatively high, it's anticipated to pick up as well.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. I am not going to try to defend Wall Street, but I think there is another aspect to this market behavior we have observed, and that is, as we all know, that we have a tremendous growth in debt in the economy. And when you get markets whipping around like these have, there are losses out there. It would be fortunate, in a sense, if a $275 million loss ended up with Merrill Lynch; they can afford to take it. But what if one of those ended up in Financial Corp. of America or one of those? Maybe it has; I don't know whether it has or not. All I'm saying is that this kind of behavior tends to widen quality spreads; you see it a little in the new issues, though there haven't been many of them. But you can have a situation where somebody needs to realize liquidity with some of the lower quality paper they have bought and there might not be a bid out there. So one of the aspects that hasn't been brought out about this market behavior, which I think has been very much fueled by inflationary expectations, is the financial fragility that these kinds of swings can bring to the surface. Beyond that, as Jerry mentioned, six or eight weeks ago when we were talking about this initially, there was just a whiff of inflation; basically, it came through a weaker dollar and that psychology was transmitted into the bond market and so forth. But I think now what we are seeing is poor performance, if you will, in the bond market based on sources other than the lower dollar--other reports of commodity prices and so forth. I thought what the Board staff did in sections 23 and 24 of part II [of the Greenbook] really makes the case that there are a lot of things happening with spot prices that go well beyond the realm of what I would consider just speculative behavior. I think there is definitely a tendency out there to sort of poo-poo all of these developments by saying: this is just speculation on Wall Street and these guys deserve to take their losses anyway. In a sense, I don't think enough attention is paid to it. We had some corporate treasurers in last week and, in terms of how they are operating their businesses, I was a little surprised that they are not concerned about inflation. They are still enjoying the good wage performance that we have observed; of course, that would only adjust with lags. They haven't really changed their inventory behavior and, in a sense, I think that gives us an opportunity. If we nip this in the bud now--when maybe it is largely expectational, as Gary Stern said before--we can have some impact on it. But if it gets deep-seated enough that business people begin to change their behavior with respect to inventories and so forth, then it really becomes a much more difficult problem to deal with.

As to economic activity in our District, growth both in manufacturing and non-agricultural employment in general continues to outstrip the national figures. I would say that the attitude is generally positive and that there are no major weaknesses in any sector.

CHAIRMAN VOLCKER. Mr. Heller.

MR. HELLER. I find myself much more in agreement with the numbers in the Greenbook than with the general tenor of the discussion here. Looking at the numbers, first of all, we have a sharp downtrend in GNP from 4.3 percent to 2.2 percent in the third quarter. Domestic purchases are going down to 0.9 percent in the third quarter and 1.3 percent in the fourth. On the inflation front, so much pessimism has been expressed, but the GNP deflator is actually declining to 2.6 percent in the fourth quarter of this year and nominal GNP is cut by about 1/3, from 7.8 percent in the first quarter to 5.5 percent in the fourth quarter. So both the real economy, as well as the aggregate inflation numbers, are trending downward for this year. Next year it goes the other way. As we all know, production in March and April was rather dismal in every single category except defense, where it was flat. Inventories were up sharply in the first quarter. Consumer credit was slowing down a lot. Thank goodness, in a way, there was also less federal stimulus. The one area where I disagree with the Greenbook is that I think it is probably a bit too optimistic on the very sharp swing in exports and the improvement in the trade performance it projects. It projects an export swing from a growth rate of minus 1.6 percent in the first quarter to plus 17 percent in the fourth quarter. The aggregate numbers go from a minus $134 billion to minus only $46 billion by the fourth quarter of next year. In other words, by the end of next year, 2/3 of our trade imbalance would have been eliminated. In view of the slow growth abroad that has been noted by many other speakers, I am rather skeptical that we actually will be able to achieve that.

CHAIRMAN VOLCKER. Those are not real numbers. Practically none of the trade imbalance would be eliminated in nominal terms.

MR. HELLER. No, they are real numbers; they are 1982-base real numbers. In addition, we have a real interest rate, as we were told yesterday, of 4 to 5 percent, which incorporates a bit of the extrapolation of current expectations. And we continue to have our problems in the financial sector. Overall, I come out on the rather subdued side, if not outright pessimistic.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. I am very much of the view that inflation is a real problem for us at this point in time. If we wait until the GNP deflator and the CPI show a problem, we will have waited much longer than I think historical evidence would suggest we should wait. I recognize that a lot of the commodity price movements look like they are extra-sensitized to circumstances, but it's this sensitivity, surrounded with the attitudes concerning the dollar and commodities that are linked hand in hand, that is so worrisome. I have watched many times when a drought was actually underway and wondered why commodity prices didn't move; now commodity prices move based upon the forecast of a drought. I think that is an indication of how sensitized the players are to expectations. Some of you seem to believe that those people who are participants in the market--whether it be Wall Street or New York or Chicago--somehow or other may just have their own self interest at hand and that that's not a true test. I would be much more inclined to look at those who are putting money down than I would those who are making forecasts that are not backed by money, because it is really the shift in preference between holding financial assets and real assets that is involved. We have a phenomenon that is emerging that is significant, and it seems to me it will continue until there is marketplace realization that the Federal Reserve plans to follow a scarcity path for the monetary aggregates that will slow down. So I am somewhat of the opinion that we had some gains out of this because, certainly, it does give real sector stimulus any time you have commodity prices move upward. Our economy I thought was weak enough going into 1987 so that a little stimulus wasn't a bad thing. But it seems to me that we now have to face the test as to whether or not we really mean price level stability. I think that the Greenbook puts it very well: that if we choose not to do that, then that's consistent with a continuing decline in the exchange rate of the dollar. Over time, I think that will not give us any better improvement in our nominal trade balance than we would get if we dealt with it, because we will just incorporate a rate of inflation into the U.S. economy that I think matches this falling value of the dollar. So, I am of the opinion that we have given this plenty of opportunity to see that it's a real phenomenon.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I must admit I am a little torn between which way things are going. I don't have a clear view myself. Obviously, the financial markets are indicating some inflationary expectations. The question is--and it has certainly been the question here--whether we think they will be realized or not and whether we want to bet against the markets or whether we think something more needs to be done or has already been done.

In terms of the Greenbook forecast, I agree with a lot of it except that one of the major factors feeding into the projection of rising inflation in 1988 in this forecast is further expectation of a weakening dollar. Of course, that feeds right into import prices; so in the forecast you don't have a one-time adjustment in import prices that washes out over time. You have a continuous feed-through of a decline in the exchange rate that is causing continued upward pressure on the inflation rate. Now, if I really thought that was going to be the case, I would be a lot more concerned. It may be possible, so I think that we need to concern ourselves with stabilizing the dollar at some point. If I thought the dollar was going to deteriorate on a continuing basis, I would have some concern about the continued upward pressure on the inflation picture. So, I would hope that we could achieve some conditions that would stabilize the dollar without a continuing deteriorating trend. I think the question then is: What does it take to do that? We now see some growing spreads in interest differentials between the United States and our other trading partners. My own opinion is that, hopefully, we are getting to the point where the dollar is finding some legs under it and will have to stabilize. I think the real question is whether we have done or are about to do enough in monetary policy to convince the markets that we are dealing with the inflationary risks in terms of the dollar and other domestic pressures on inflation. As Peter Sternlight pointed out, borrowings--inadvertently or advertently--averaged $700 million over the last intermeeting period. I am not sure whether we want to go further than that or whether I personally want to continue that sort of a borrowing assumption. So I think the question is: What does it take to stabilize these conditions? I don't want to overreact and deal with more than just what the inflationary risk is.

CHAIRMAN VOLCKER. Mr. Kohn, maybe you can give us a brief analysis.

MR. KOHN. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Let me mention one thing that I was going to discuss later. I will discuss it later, but some rumors are flying around the markets so I thought I should identify it now, anyway. Citibank is making the great move this afternoon, unless the market forces them to announce it earlier. They are making a reallocation of their capital accounts and are going to put $3 billion into reserves against general contingencies, which will get pretty precisely identified with LDC risk. They say that is not their intention but the accountants are forcing them into it, looking for some explicit excuse. This will be a record loss for any bank, by some multiple, in a quarter, and a big loss for the year. I am sure the idea they have in mind is that they will then show very favorable earnings in subsequent quarters; they won't have this quarter-by-quarter drag of large provisions and everything is going to look much better. In fact, what's happening is that a couple of numbers on the balance sheet are changing. It is going to raise a lot of questions, obviously, in the minds of a lot of people about other banks. There are a lot of rumors about around the market. We can discuss later what is going on in the market.

MR. PARRY. Paul, are the rumors sufficient that I could call an institution that I might have some concerns about?

CHAIRMAN VOLCKER. The problem is that I don't know what you can tell them right now because we have inside [information]. We have this problem with some banks; that is right. I just don't know what you can tell them.

SPEAKER(?). Not to go out to lunch, I think.

CHAIRMAN VOLCKER. You can talk to them if you want and see what they know, because they are obviously the other bank that will be very much affected by the psychology. A lot of them will be but--

MR. BLACK. Why don't you say we were sitting around the Open Market Committee table and didn't know what was happening and wanted to--

CHAIRMAN VOLCKER. On our more immediate problem--I don't know, that problem could be pretty immediate in terms of the decision we have to make--it is obvious that one of the variables for the Federal Reserve as a whole, but not for the Open Market Committee, is a change in the discount rate. A number of Federal Reserve Banks have made a proposal and we have had some discussion. I don't know what I can say about that. We could change it immediately; we could change it if the dollar seemed to require; or we could change it not at all. I think those are the three options before the house. I just think we have to have those in mind as possibilities; it may affect one's judgment about how to conduct open market operations. For what it is worth--if I mention this there is a chance you will be overly influenced, but I suppose not these days--our latest M1 numbers look a little stronger than what we thought yesterday. Instead of unchanged in May, M1 may be up a little.

MR. KOHN. Instead of down a little in May, it now looks like M1 may be up a little in May.

MR. JOHNSON. You might point out that there is a special circumstance in it.

MR. KOHN. Well, for some of it. Even abstracting from that the numbers are a bit stronger.

MR. PARRY. Do you mean an unwinding from April? Is that the special circumstance?

MR. KOHN. No, there is another transaction we are trying to track through the System that may be boosting demand deposits in the current week; we don't have a really strong handle on it, but that is what Governor Johnson was referring to. But even before the current week, it is still looking a bit stronger than we had expected.

MS. SEGER. What is happening in the money markets this morning?

MR. STERNLIGHT. Federal funds are about 6-3/4 percent. Borrowing was about $600 million yesterday, so it is averaging a little over $500 million. We are well over our reserve paths for right now, at $600 million or so, and we plan to just let that work its way into the money market. If those estimates are right, things ought to ease off considerably. We ought to lose a bunch of the remaining repurchase agreements that are on, although so far that is happening quite slowly.

MR. BLACK. Do you think it is going to reverse itself without help from you, Peter? Or do you think you will have to unload some?

MR. STERNLIGHT. As the reserve period draws to a close tomorrow, if the numbers that we are looking at stand up, there ought to be a big easing at the end of this reserve period.

CHAIRMAN VOLCKER. Who would like to say something? Mr. Parry.

MR. PARRY. Mr. Chairman, I would support Bluebook alternative C. It seems to me that the prospect of high inflation is the main reason to support some tightening from the stated policy at the present time. As I mentioned before, it is my view that the economy is certainly close to full employment in terms of labor resources, and we expect the economy to expand this year at a rate which is slightly faster than its current long-run potential growth rate. It seems to me that this consideration is particularly important now because of the declining dollar and recent increases in oil prices, which are causing and will cause inflation rates to go up even without any demand pressures. I think there is a danger that increases in inflation this year and next could become imbedded in inflation expectations. And, given what I think is the apparent strength in the economy, the risk of cutting economic expansion short by such a tightening of policy seems to be small. I would have a preference, too, as to how that is accomplished if that is something you want brought up.

CHAIRMAN VOLCKER. You were just saying alternative C; I was looking at it literally to say either an increase in [the borrowing built into] the reserve path or an increase in the discount rate.

MR. PARRY. Yes. I would prefer an increase in the discount rate. I was going to say that sooner would be better than later but I must admit that this little item that you brought up would suggest to me that maybe it should be a little later.

CHAIRMAN VOLCKER. Yes. Mr. Boykin.

MR. BOYKIN. I would agree with what Bob Parry just said and I really can't add very much to it. Alternative C does look like the best alternative to me. A lot of reference has been made to inflation and that it is probably not real; but there is some expectation there and it seems to me that what we really need to move against is the expectation. That was what was probably so hard to wring out the last go-round. So, I would go to alternative C. Likewise, I would probably favor an increase in the borrowing assumption from $400 million to $600 million versus a discount rate change right now.

CHAIRMAN VOLCKER. You would prefer the borrowing.

MR. BOYKIN. Yes. Primarily with what is going on that we just want to--

CHAIRMAN VOLCKER. Yes.

MR. JOHNSON. Can I ask a question again? Alternative B is associated with $400 million in borrowing? Okay. This is kind of confusing because, in some sense, "C" is actually a more modest borrowing level than we have been experiencing. It is definitely below the average during this last intermeeting period. I think the question is: What would we expect to happen? Are we going to see a borrowing average of $600 million or what is it going to be? Are we going to try and truly target a $600 million borrowing level so that we are talking about a tightening of policy relative to the $400 million level that we sought? I guess that is what I am asking.

CHAIRMAN VOLCKER. I'm not sure I understand the question. We were truly seeking what we were seeking before; we may not have made it. When we say $600 million, or whatever, we shall truly seek it.

MR. JOHNSON. Well, I don't think we truly sought $400 million. I don't think that there is any doubt: you can't go through an entire six-week intermeeting period with a $400 million target and hit $700 million and say you truly sought it. I think we could easily have offset that; it wouldn't have been--

MR. BOYKIN. But we didn't start out there; we actually started out with $300 million, leaning in favor of moving that up depending on what happened to the dollar.

MR. JOHNSON. From $300 to $400 million; that is different from $300 to $700 million.

CHAIRMAN VOLCKER. I would submit that we've had two two-week periods, which is two-thirds of the time between the meetings, where we couldn't hit it.

MR. JOHNSON. I recognize the serious problem with the Treasury account at the Federal Reserve. But as that continued and we could see that borrowings were going to run very high, we could have done more on the reserve side. Given what was happening to the dollar, we shouldn't have. But I am just saying when we are crossing over into something that is a change in policy, I would just like to clarify where that is. At some point, going to $700 million borrowing from $400 million or even $500 million seems to require something other than just saying--

CHAIRMAN VOLCKER. I tell you. Let's defer those questions until we know what we want to do in concept. Mr. Keehn.

MR. KEEHN. I share Governor Johnson's confusion on this. I would be for alternative C, at least conceptually, because I think that represents a slight snugging and, for all the reasons we have said, I think that is appropriate at this point. I also think it is perhaps appropriate to take a step that is a bit visible in terms of reinforcing our policy of price stability and, therefore, I would be in favor of recommending to you a change in the discount rate. I don't know how to evaluate this Citibank issue as to what kind of effect that is going to have on the market. Certainly, that has to be behind us before we take any move on that. But I would be in favor of changing the discount rate. And alternative C is a way of moving a little against this.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I am a little concerned about these inflationary expectations in the economy, but like some others here, I don't see it being translated at the moment into anything that is terribly worrisome in real numbers. My greater concern is with the state of the economy and what a higher level of interest rates would bring not only to the domestic economy but to our trading partners and the LDCs. So, if we need to do some tightening, I would like it to be small in scope and very gradual. The dollar has stabilized; maybe we are at a level we are not comfortable with, but it has been around the 140 level against the yen. I would prefer it to move up just a bit. I, too, am a little confused about what we are keying off of. If it is $400 million that we are using, I wouldn't mind moving to $500 million. I would suggest that a discount rate might be saved for a more significant development with respect to the dollar--if the dollar were to move down or inflation actually did move. I would prefer just to use open market operations in a very gradual, slight, way over the next intermeeting period. I am not sure whether that is "C" or "B"; I suppose, conceptually, that I am somewhere between the two.

CHAIRMAN VOLCKER. Mr. Hendricks.

MR. HENDRICKS. It seems to me that the best course is closer to "C" than to "B", unless the expansion weakens or the current turnup in prices subsides. Financial markets seem to have marked up inflation expectations. We don't see a pickup in prices working into the cost structure yet, but when it does occur, we feel it would be more difficult to deal with. Markets have snugged a little, with the funds rate up to the 6-1/2 percent area or slightly above. We believe that a borrowing level consistent with that outcome is appropriate. It would reduce the risk that inflation expectations would generate future price pressures and would provide some insurance against rising import prices becoming the basis for domestic price increases. We would prefer to set the borrowing level at $600 million and hold on the discount rate.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I would support alternative C because, despite my earlier statements, I think if we were to go for alternative B, we might give the market an impression that we were easing policy and that could, of course, be very troublesome. I think "C" is more in line with what, in fact, we have been doing and, as was indicated earlier, represents more of a no-change policy than "B". With respect to the discount rate, I think we ought to keep that in reserve for use when we have the next downward fall in the exchange rate. I don't know when that is going to come, but it seems to me rather than raise the discount rate in a period of stable exchange rates, we ought to hold that to have something in our armory for use on that occasion.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. I am in favor of no tightening. I am not sure which alternative that is, the way these things drift. As I said earlier, the real economy is very sluggish. Furthermore, I don't see any sign of real life in any sector; certainly, I don't see any sector overheating at the moment. As Manley said, we've already tightened. What I think we have is something that is beyond alternative C last time; I believe that the majority voted for maintaining, which was alternative B. Also, we have not seen in the real economy yet the effects of the tightening that we already did. The world economy is sluggish, and even the staff has revised its projections of the growth in industrialized countries. The important danger, I think, is that we will tighten monetary policy and the foreign countries are not going to offset with some easing on their side. Also, the monetary aggregates have slowed and are expected to be weak. I think a recession would be a disaster. It would certainly not make our budget deficit any better. It would hurt the lesser developed countries; it would make their debt burdens a lot heavier. It would not help the financial system, particularly the savings and loans that are already sort of shaky. And, finally, I don't think inflationary pressures can exist very long in an environment with excess capacity and commodity gluts worldwide. I would like to vote for "B" but not a "B" that would drift.

CHAIRMAN VOLCKER. "B" is where [unintelligible] drift. Mr. Stern.

MR. STERN. I favor alternative C, which seems to me not very far from where we are at the moment. It seems to me appropriate under the circumstances, given the continued vulnerability of the dollar and what we are seeing--at least what I think we are seeing--in the price numbers. I know that it is possible that what we are seeing here is simply large relative price changes in some commodities and energy, and so forth. But I think the bond market is telling us something different. Given the policies that we have pursued over the last couple of years--not just monetary policy, but fiscal policy--and given what has happened to the dollar, in some sense, one could ask the question: What has taken the markets so long to react the way they have? So, "C" seems to me to be appropriate, and I would prefer to couple that in the relatively near future with a discount rate increase. At this point in time I think that has a chance, at least, of being salutary as far as the dollar and the bond market are concerned.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I am for alternative C and I think we ought to have a discount rate increase. I think a discount rate increase now or relatively soon buys us more than if we wait a few weeks. I don't think they are of equal value. The longer we wait the more it gets discounted and just doesn't buy us very much. I think it would have been worth more a week ago and will be worth less two weeks from now. So, I would move fairly promptly on the discount rate in conjunction with "C."

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. I would be in the same position that Ed Boehne just expressed. I think that if we wait on the discount rate until there is another test on the dollar, there is a good chance that a 50 basis point move wouldn't be enough. By showing some resolve sooner, I think we have a better chance of dealing with that. Also, as Gary Stern pointed out, that deals with the inflationary expectations decisively.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I apparently led some of our colleagues into thinking that I did not see any inflation pickup at all. All I meant to convey was that I thought that markets may be anticipating more than, in fact, is likely to happen. I do think that inflationary expectations and some indications of inflation have actually appeared. But, in view of the weakness in the domestic economy and even greater weakness abroad, and now this Citibank situation, I think maybe we ought to proceed with some caution. I was inclined to favor a position that was more a "B-minus", but after listening to comments around the table, I think what I really would like is a level of borrowed reserves that would produce a federal funds rate of around 6-3/4 percent, as it has been recently. I'd put that in either the "B-minus" or the "C" category. I would also favor going toward variant II [of the directive language], and moving that foreign exchange reference back to its usual position. And I would like to use "would" and "might." Also, I think it might be worth considering moving up that point on the concerns about inflationary pressures before the reference to the strength in the business expansion as a way of showing that that is now a more important consideration. This refers to what you'd find in the directive language with the brown cover on lines 110 and 111 or on page 15 of the Bluebook. And, I would hold that discount rate move in abeyance for a while in case we get some real pressure on the dollar so that we could move very quickly on it at that time. I don't feel terribly strongly about that.

CHAIRMAN VOLCKER. Governor Heller.

MR. HELLER. I agree largely with what Mr. Black just said; I am also in favor of "B-minus," especially in view of the fact that M2 is lying at a level substantially below the target cone and M3 is just at the bottom end of the target range. Like Mr. Black, I am also in favor of variant II, moving the foreign exchange language further down in the priority list.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I stand in the "C" category, mainly because I think that is basically no change in current policy operations. I think that would be consistent with about a 6-3/4 percent funds rate, or something like that, maybe even less. But I see two things that could be done with "C" that could involve both the adoption of a higher borrowings and a discount rate change, without a further move upward [in the funds rate]. If we want to hold off on the discount rate, [saving it] as ammunition for a future event in terms of the announcement impact, we could go ahead and change the borrowing level to $600 million from the $400 million but have some sort of contingency where, if we decide a discount rate change is needed later, then we would lower the borrowing. The discount rate change would be a substitute so that there is no additional pressure on the funds rate but we get the announcement effect of the discount rate. So, it is not impossible to do both with the same policy. I would support "C" assuming--and that is why I had the technical question earlier--that "C" represents basically current operating procedure, and I would add the option of the discount rate substituting for that at a lower level of borrowing at some point when we might want to use it. I don't know what the possibilities are, but the Chairman made it clear that it is probably not very likely that we could work out some sort of coordinated move with Japan of Germany.

CHAIRMAN VOLCKER. I think the probability is zero now.

MR. JOHNSON. Zero. Yes, I think that is right. My suggestion is that we go ahead and adjust the borrowing but then reserve the discount rate for a point when--maybe not this week but next week, or whenever, depending on developing events in the exchange market--that might be something that could be used. So, to some extent, you get the dual effect of the announcement of the discount rate and the higher borrowing level within the same period without really having to make an adjustment. That would be my preference. I don't know what you would call that; I guess you would call that "C" with a variation.

CHAIRMAN VOLCKER. It is "C."

MR. JOHNSON. Yes, acute "C."

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. In my view, what has happened is not a result of Federal Reserve monetary policy management. The fact that we have a 6-3/4 percent, or a 6-7/8 to 7 percent, funds rate is largely a result of the markets' misconception or perception of what has occurred. That is, I still view our borrowing target as $400 million, with $850 million excess reserves; with the technical problems that the Desk has encountered, we didn't hit that simply because the market took it elsewhere. Further, given the forecast of domestic growth--which is fairly modest, it seems to me, at 2-1/2 to 3 percent--the only reasons that one could justify raising the interest rates at this point, either through open market operations or the discount rate, are: (1) if you were concerned about inflation, and I don't share that at the moment; or (2) to support the dollar. It is my understanding that for the moment the dollar is fairly stable. So, neither one of those two things looms very large to me and, as a result, I would probably generally opt to go with "B." But given the uncertainty in the market and the fact that they have taken the rate up, to come down too quickly would put some downward pressure on the dollar. As a result, I would go with a "B/C", with a borrowing level of about $500 million. But that would be simply to moderate the downward movement of interest rates if we can achieve that without putting pressure on the dollar.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. I am very sympathetic to the point made by Ed Boehne, and seconded by Tom Melzer, that there would be more clout from a discount rate change if it were to occur prior to moving to, or confirming, a $600 million borrowing level. I think it would have more impact. But since the Governors of the Board will be the ones voting on that, I belong in camp "C."

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. I would be for "C" too. As far as the Boehne/Melzer/Angell twist, that is something I have some considerable sympathy for--trying to get out ahead of this a little. I think a discount rate change now would give us the kind of maneuvering room that Manley mentioned, as well. I might be a bit more skittish about the discount rate this morning than I was yesterday, just because the market has gotten pretty jumpy in the context of this Citibank development. But the right policy, in my judgment, is the Boehne/Melzer/Angell twist on this, which affects the timing, as far as I'm concerned.

MR. JOHNSON. Another question. If we went for a discount rate change soon, and that was the policy, what borrowing would go with that?

MR. ANGELL. Well, it seems to me that a $400 million borrowing assumption should go with the discount rate move to give you "C." And then if conditions changed, that would call in the rest of our directive as to the room we would have later.

VICE CHAIRMAN CORRIGAN. Peter, is that how you and Don think about it?

CHAIRMAN VOLCKER. That is what "C" says.

MR. JOHNSON. Yes. That is right. Now that I think about it, it is in the Bluebook that way.

CHAIRMAN VOLCKER. All this perceived wisdom says that half the people would like to see the discount rate moved right away and half the people would not like to see it moved.

MR. ANGELL. Well, Mr. Chairman, you haven't voted yet.

CHAIRMAN VOLCKER. That is correct. I would interpret most people's comments as indicating that they are reasonably happy in a very general way with the way things are now. How do we express that in detail? I guess it depends on what we do with the discount rate.

I will look at the wording to see what wisdom that implies. Very broadly, is the preference for variant I or II? A couple of people said they would like variant II and many didn't say anything. I am not worried about the precise words in either one, but variant I clearly gives more prominence to the exchange rate. Is that closer to the center of gravity or the reverse?

MR. JOHNSON. My preference would be to emphasize the inflationary expectations issue. I guess that is in variant I--it has the exchange rate mentioned in there but not as prominently as the indications of inflationary pressures.

MR. BLACK. You've got that in Variant II, Manley. I wonder if you would be amenable to putting that in front of the strength of the business expansion, which is the idea that I threw out.

MR. JOHNSON. Okay.

MR. BLACK. I think it gets to the same sort of thing.

MR. KEEHN. Are you saying, Bob, variant II but move the inflationary pressure phrase up in the sentence?

MR. BLACK. Yes, that's what I would do: move it up to line 110 instead of 111 and put it right ahead of the "strength in the business expansion."

CHAIRMAN VOLCKER. I think it is pretty close.

MR. BLACK. Well, it is; I grant that.

CHAIRMAN VOLCKER. I think the argument is straightforward; we can move up the inflationary pressures phrase. I feel that a lot of comments suggested that maybe the timing of the discount rate ought to be primarily influenced by one thing or the other. Whatever one concludes about the timing is a foreign market question. And, if an inflation expectations question is really what we are talking about, then I am not so sure whether we're not better off putting inflation in with the exchange market in the first clause: "developments in foreign exchange markets and indications of inflationary pressures"--or vice versa--"taking into account..." etc.

MR. ANGELL. Yes, let's do that. Put inflation in front of the dollar. Let's go with variant I, but put inflation in front of the foreign exchange.

CHAIRMAN VOLCKER. "Depending on indications of inflationary pressures and developments in foreign exchange markets."

MR. ANGELL. Yes.

MR. BOEHNE. I like that.

SEVERAL. I agree.

CHAIRMAN VOLCKER. --developments in foreign exchange markets, taking into account the behavior of the aggregates," then why don't we just say "and the strength of the business expansion"?

MR. KOHN. The phrase "conditions in credit markets" is there at the end of that sentence.

CHAIRMAN VOLCKER. I know, but does that add anything?

MR. ANGELL. No. Let's leave it out.

MR. HELLER. The aggregates are thrown out too.

CHAIRMAN VOLCKER. No. "Taking into account the behavior of the aggregates and the strength of the business expansion." We can leave in credit market conditions; I am not sure what it is supposed to mean in this connection.

MR. ANGELL. With inflationary pressures highlighted, I think the credit market conditions might be reflected by that same phrase. If it is, we don't need--

CHAIRMAN VOLCKER. I suppose that phrase is meant to say if conditions in the credit markets are too bad, we would get easier.

MR. KOHN. Yes, at least the Committee would take that into account if a serious problem arose. At one point it said foreign and domestic credit markets.

MR. ANGELL. Well, I think we ought to leave it out.

MR. KOHN. If a problem--

CHAIRMAN VOLCKER. Let's go back to the earlier part of that sentence.

VICE CHAIRMAN CORRIGAN. It raises a question in my mind as to what we're thinking of.

CHAIRMAN VOLCKER. "This approach is expected to be consistent with growth in M2 and M3 over the period at annual rates of 6 percent or less" is what we had.

MR. ANGELL. I still like 3 to 7 percent.

CHAIRMAN VOLCKER. What is the projection explicitly?

MR. ANGELL. Well, because M2 does run a little low; on M3--

CHAIRMAN VOLCKER. Well, it's "the aggregates." If M2 runs low--

MR. HELLER. M2 runs low.

CHAIRMAN VOLCKER. But the projection is about 6 percent for M3 and only 3-1/2 to 4 percent for M2. We can say "4 and 6 percent, respectively,: or we can say "6 percent or less."

SEVERAL. 6 percent or less.

MR. JOHNSON. Say around 6 percent. I don't care; I am not getting into this one again.

CHAIRMAN VOLCKER. Just reading what we have here: "Growth in M1 is expected to slow substantially over the balance of the second quarter."

MR. ANGELL. I don't think that--

MR. KOHN. Compared with 18 percent.

CHAIRMAN VOLCKER. That is a great daring statement: it may be below 18 percent for the rest of the quarter!

MR. ANGELL. It looks to me like you are apt to get double-digit rates for the quarter. What do you think, Don?

MR. KOHN. Well, you could. We have an 8 to 8-1/2 percent growth rate in the path; but you can't rule out a 10 percent pace. The previous directive had something about M1 is expected to remain substantially below its pace in 1986, which is pretty safe since that pace was 15-1/4 percent.

CHAIRMAN VOLCKER. We could say something even safer--below 18! We said it would be below 15; we now say below 18. Can we say something a bit more substantive maybe?

MR. BOEHNE. We don't know what will happen.

MR. ANGELL. Say below its pace in the first quarter. It was 13 percent in the first quarter. I think it is safe to say it will be below 13 percent.

CHAIRMAN VOLCKER. 13 percent was the average?

MR. ANGELL. The first-quarter average over the fourth-quarter average.

CHAIRMAN VOLCKER. What was it, say, December to March?

MR. KOHN. I'm not sure. November to March it was 11 percent. December to March probably was less than that because December was so high. I don't know what the December to March rate was.

MR. ANGELL. I can give you the December 31 to March 30. With the hump taken out, it was 5-1/2 percent. But with the hump on it was--

CHAIRMAN VOLCKER. We can say below its pace in the first quarter, but there are two ways of looking at the first quarter. It is--

MR. KOHN. Q-IV to March was 10 percent. December to March would have been single digits. Dave Lindsey, I hope, is getting the number right now.

VICE CHAIRMAN CORRIGAN. Doesn't over the quarter usually convey December to March?

CHAIRMAN VOLCKER. It would to me.

MR. KOHN. 4-3/4 percent.

CHAIRMAN VOLCKER. It was only 4-3/4 percent. Say 10 percent or below. That's a little--

MR. ANGELL. That's all right. You may have to ease policy a little to achieve that, but that would probably be very appropriate.

CHAIRMAN VOLCKER. Say 6 percent or less for the broader aggregates and growth in M1 is expected to be 10 percent or less.

MR. ANGELL. Yes, that would be fine. That would be appropriate restraint.

MR. KOHN. Trying to make a little mental allowance that we have a special factor here that may give it a little boost, I would say "around 10 percent or less" to give us a little--

MR. ANGELL. Saying "expected" is--

CHAIRMAN VOLCKER. "Expected" is what we say about the others. That worries me a little. Does this mean that M1 has the same importance as M2 or M3?

MR. JOHNSON. I definitely think we should downplay that.

MR. ANGELL. The problem is it is more influenceable than M2 and M3--that is, if you really want--

CHAIRMAN VOLCKER. We have already said we don't have a target for it. We can have a target for it, but is that what we are doing?

MR. JOHNSON. No, I don't want to.

MR. HELLER. But when you say 10 percent or less, what are you taking as the base?

MR. ANGELL. You're taking the second-quarter average compared to the first.

CHAIRMAN VOLCKER. End of March to the month of June.

MR. HELLER. In March you have a very low--

MR. JOHNSON. You're going from a low base to a big April number and that is going to be--

MR. HELLER. You're pushing way above the 10 percent.

MR. ANGELL. Yes, but April comes back off. It is not measuring April. It is point to point.

MR. JOHNSON. You are still raising the base from which it has to--

MR. BOEHNE. I have a couple of problems with specifying a number. First, I think it conveys that we now know more about M1 specifically than we did a few months ago, and I don't think we really do. Secondly, in the same directive that we move inflationary pressures up to the top of the list, do we want to put a double digit figure for an aggregate like M1? I just think that sends the wrong message.

CHAIRMAN VOLCKER. That's all terrific. What language do you suggest?

MR. BOEHNE. "Growth in M1 is expected to slow substantially from its pace in 1986" or "to be below its pace in 1986."

MR. ANGELL. Just leave it the same as we had the last time.

MR. BOEHNE. Essentially.

MR. ANGELL. If you want to be vague, that does it.

CHAIRMAN VOLCKER. "Growth in M1 is expected to remain well below." I was worried about "this approach is expected to be consistent with M2 and M3." Do we want a stronger phrase than that? We make this sound more like a target which it is supposed to be. "Expected to be consistent"--the magic words. Oh, forget about it. We'll leave the funds range 4 to 8 percent. Now the substantive issue is--to go back to the beginning of the first sentence--we don't have to make it fully asymmetrical, but last time we didn't leave in the clause about slightly lesser or somewhat lesser. We just said the last time "somewhat greater reserve restraint might." One way to do it is "somewhat greater reserve restraint would and slightly lesser reserve restraint might."

MR. JOHNSON. It seems to me that this time there is no contingency; we are stating a change in policy. "Might" and "would" are not necessary. We just state what it is.

CHAIRMAN VOLCKER. We do? It's nice to know--we haven't gotten to the first sentence yet. I think it probably should be not quite so asymmetrical as last time, which was fully asymmetrical. If we keep this general structure we can say: "Greater reserve restraint would and somewhat or slightly lesser reserve might." Or we can make them both "somewhat" and make one word a "might." Let's go back to the first sentence. I think we can either say "maintain" or "increase." If we say increase, we will say "increase the degree of reserve pressures sought in recent weeks" and it will all be explained in the policy record. Or we can say "maintain the existing"--

MR. ANGELL. I think it should say "increased somewhat." Because from the last policy directive--

MR. JOHNSON. As long as it is made clear that that is relative to what we sought.

MR. ANGELL. Assuming that there is no great tidal wave here to release the minutes earlier than the next meeting, it would seem to me that what should be in the record is increased reserve restraint.

MR. BOEHNE. I agree with that.

MR. JOHNSON. I do too. I just think it should be made clear relative to what.

CHAIRMAN VOLCKER. [Unintelligible.]

MR. ANGELL. It is increased reserve restraint relative to the position.

CHAIRMAN VOLCKER. It says increased. Somebody thinks it ought to be "the degree of reserve pressure sought in recent weeks."

SPEAKER(?). You have to read it against the background of what we said in the policy record earlier.

MR. MELZER. One concern that I have is that all we have done, in effect, is just ratify the level of reserve restraint that we have right now. Listening to what Sam and Peter said, that there might be some expectation out there--

CHAIRMAN VOLCKER. Presumably we could be very technical; the borrowing average in this two-week period will probably come out around $500 million.

MR. MELZER. Yes. I am not talking about the minutes now.

CHAIRMAN VOLCKER. Reserves--

MR. GUFFEY. But we sought $400 million.

CHAIRMAN VOLCKER. That is correct. But it is not going to be $600 million.

SPEAKER(?). We may get a lot of borrowings tomorrow.

MR. ANGELL. Well, it seems to me that we have already decided what we want the policy to be. What we now are doing is discussing what we want the minutes to say when they are released in six weeks. It seems to me that the minutes should say that we have somewhat increased reserve restraint.

MR. HELLER. Going from existing levels.

MR. JOHNSON. No. I think going from seeking $400 million to seeking $600 million is a pretty good change. I agree from existing conditions it is not big; it shouldn't be noticeable in the funds market.

MR. ANGELL. Well, let's use the word "sought."

MR. BOEHNE. That's what is in there.

CHAIRMAN VOLCKER. When is the last time we used this kind of formulation? You say we have used it several times?

MR. KOHN. I'm not sure. Maybe Mr. Bernard has that.

CHAIRMAN VOLCKER. When we have used it, I think we have had exactly this same problem. There is a debate about whether we want to get public credit for tightening up. We're actually tightening.

MR. JOHNSON. We are tightening after the fact.

MR. KEEHN. I wouldn't feel strongly about it, but in light of the fact that we have tightened and we are suggesting wording that we are, would there be any sympathy for moving toward the federal funds range consistent with "C," namely 5 to 9 percent? That would put the rate we are getting about in the middle of that range.

MR. JOHNSON. That goes with "C" anyway.

MR. ANGELL. No. I thought the Chairman said 4 to 8 percent.

CHAIRMAN VOLCKER. 4 to 8 percent is what we have been using.

MR. KEEHN. I am suggesting that in light of changes that have occurred in the rate structure and the way this drafting is beginning to shape up, would there be a basis for changing the federal funds range to 5 to 9 percent?

CHAIRMAN VOLCKER. Yes. I would think that is unlikely but it could conceivably happen. It is a question of how we want it to read. I think most of the time we have not moved the range when we are this far--and where we would anticipate being is this far--from the edge. That is much more frequently [the case] than not. We have not moved it until we get quite close to the edge.

MR. HELLER. From 4 to 8--

CHAIRMAN VOLCKER. But it is all psychological. Well, what do you want to say? "Seeks to increase somewhat the degree of reserve pressure sought in recent weeks"? One question is whether we want to say--which we have also done at times--"depending upon the level of the discount rate," or "taking into account any changes in the discount rate." In the directive of August 19, 1986, we said "In the implementation of policy for the immediate future, the Committee seeks to decrease slightly the existing degree of pressure on reserve positions, taking into account the possibility of a change in the discount rate."

MR. ANGELL. I don't think we need to mention the discount rate.

CHAIRMAN VOLCKER. I don't think we have to, but probably it will have to be mentioned in the text [of the policy record] that how we will conduct open market operations will depend on what the discount rate move is.

MR. BOYKIN. I think I would because I think it would make a difference. Not knowing what the Board will do on the discount rate, I would go for the $600 million borrowing assumption. If I knew the rate was going to change, I would go for the $400 million.

MR. ANGELL. Well, I thought that was assumed by everyone.

MR. BOYKIN. I think the comment on the discount rate should be there for those of us who don't get to vote on that--that at least we have it in mind as a possibility.

CHAIRMAN VOLCKER. I think that it has to be in the policy record anyway. There is a more limited question here: whether it has to be mentioned in the directive itself.

MR. BOYKIN. I am arguing yes.

CHAIRMAN VOLCKER. We will interpret the degree of reserve pressure in the text to mean a composite of borrowings and discount rate, which is what we have done before. I think that has been established many times. So, presumably this degree of reserve pressure will be read as some combination of discount rate and borrowings, whether or not the discount rate is explicitly mentioned in this particular sentence. I will declare that. Still, it doesn't answer the question of whether it is better or not visually to put some mention of it in there. It will be reasonably clear, I trust, in the last few paragraphs of the policy record leading up to the directive that the Committee very much had in mind that we might have a different level of borrowing depending upon what the discount rate is.

MR. GUFFEY. Having said that, Mr. Chairman, what level of borrowing do you have in mind?

CHAIRMAN VOLCKER. I will get to that in a minute. How many want the discount rate mentioned in this sentence?

MR. JOHNSON. I am neutral; I don't care.

CHAIRMAN VOLCKER. We are going to be 5 to 5.

MR. JOHNSON. I'm not against it.

MR. ANGELL. I'm against it. I prefer not--

VICE CHAIRMAN CORRIGAN. I'm indifferent.

CHAIRMAN VOLCKER. Well, we have a number of indifferent ones.

MR. ANGELL. So, you have more votes to have it in.

CHAIRMAN VOLCKER. There are more votes to have it in, probably. "In the implementation of policy, the Committee seeks to increase somewhat the degree of reserve pressure sought in recent weeks, taking account of the possibility of a change in the discount rate."

MR. JOHNSON. $600 million borrowing goes without a discount rate change; $400 million goes with a discount rate change.

MS. SEGER. What are the odds for getting an increase in the discount rate and borrowing--not the borrowing target, but actual borrowing--around $800 million? Could you conceive of that?

MR. ANGELL. We are not going to hear of any huge [unintelligible] gains of a type that we are unable to offset.

CHAIRMAN VOLCKER. "In the implementation of policy, the Committee seeks to increase somewhat the degree of reserve pressure sought in recent weeks, taking into account the possibility of a change in the discount rate. Somewhat greater reserve restraint would or somewhat lesser reserve restraint might be acceptable depending on indications of inflationary pressures and on developments in foreign exchange markets, taking into account the behavior of the aggregates and the strength of the business expansion. This approach is expected to be consistent with growth of M2 and M3 over the period at annual rates of 6 percent or less. Growth in M1 is expected to be well below its pace during 1986." The 4 to 8 percent range. How do we deal with [two] "taking into accounts?"

MR. PARRY. Put "depending on."

MR. STERN. Put "depending on" back.

CHAIRMAN VOLCKER. Now we've got two "depending ons"!

MR. BLACK. I think you can leave the second one out, but that may put more emphasis on the aggregates than you want to give them.

MR. JOHNSON. "Given" or "in the light of."

MR. BOEHNE. If you want to separate it, you could have a comma and then "as well as the behavior of the aggregates and the strength of the business expansion." That puts it in two slightly different categories.

CHAIRMAN VOLCKER. Well, we could do it that way, I guess. "...acceptable depending on indications of inflationary pressures and on developments in foreign exchange markets, as well as the behavior of the aggregates and the strength of the business expansion." I think clearly what we are saying, and this is too simple is: If we change the discount rate in the next day or two, we would aim around $400 million or so and if we don't we would aim at $600 million. What is more questionable is what happens if time passes and we go to--I doubt we're going to $600 million right off the bat--as a way to procrastinate, go to $500 million or so.

MR. ANGELL. On the way.

CHAIRMAN VOLCKER. Initially. And leave open whether we go to $600 million on the borrowings or just change the discount rate.

MR. ANGELL. I like that. It gives us a little more option than a discount rate change.

MR. JOHNSON. Given what we are doing today, what would going immediately to $600 million look like in the market, in your opinion?

MR. STERNLIGHT. What troubles me a little is that there is still this kind of overlay of expectation of a discount rate move. I wonder, even if action were delayed on that, if we would immediately, or starting next reserve period, put in $600 million and still look for a discount rate in addition whether that wouldn't give a little more than--

MR. ANGELL. I think that is what we want to avoid.

MR. STERNLIGHT. --what people are looking for. That would suggest, one would think, maybe $500 million or something as an in-between, to keep options open.

MR. JOHNSON. That is what I am asking. You are saying $500 million. What do people think we are putting in there? From what you said earlier, they think we are putting in something well above that.

MR. STERNLIGHT. They think we are putting in $600 million now.

MR. JOHNSON. Yes. So, I am just--

CHAIRMAN VOLCKER. Let me try this out. I think it could reasonably be $500 million or thereabouts now. If we move the discount rate we could go on the light side of $500 million. If we don't, it seems to me consistent with all this conversation that we might well go to $600 million, depending upon the exchange markets and the inflationary indications.

MR. ANGELL. What happens if we decide to do the discount rate cut earlier?

CHAIRMAN VOLCKER. Discount rate increase.

MR. ANGELL. I mean increase. Wouldn't it also be possible to do a discount rate increase and go back to $400 million?

CHAIRMAN VOLCKER. I myself think it is a little hard to reverse by any sizable amount. I am not talking about a shading. That is why I prefer not to get very tight and then reverse anything. I think it gives peculiar signals. But, if we are around $500 million, we can shade it on the low side or the high side, depending upon what we do on the discount rate, and not be way off.

MR. ANGELL. Are you suggesting that if we were to move on the discount rate today or tomorrow that going to a $400 million borrowing assumption would be--

CHAIRMAN VOLCKER. The borrowing assumption would be around $400 million.

MR. ANGELL. Well, that's what I--

CHAIRMAN VOLCKER. If we don't do that, the borrowing assumption would be around $500 million.

MR. ANGELL. Yes, I understand.

MR. JOHNSON. It seems to me that if we raise the discount rate and try to get to $400 million it would still seem like an easing of conditions in the open market.

MR. ANGELL. No it won't. You're going to have all the expectational effects that go with a discount rate move and the federal funds rate is going to tend to move.

MR. BOYKIN. There is the further question: If we go with the $500 million and then the discount rate change doesn't happen, when do we go on to $600 million?

CHAIRMAN VOLCKER. That depends upon exchange markets and inflationary pressures, and so forth.

MR. ANGELL. Yes. That would mean more tightening.

MR. BOYKIN. That is what I am trying to get at. At least as I see it, some confirmation of additional tightness is desirable--whether it is through open market operations or the discount rate. I'd argue for going through open market operations right now, particularly given whatever is going on today. That seems to me to be the way to start out today. It may be a little different tomorrow.

CHAIRMAN VOLCKER. I would suggest something like $500 million now without a discount rate change--that assuming no discount rate change, there would be some predilection--. Something else would have to happen to go to $600 million, but we would be ready to do that without too much strain. If we moved the discount rate, presumably we wouldn't go to $600 million and would shade the $500 million down. If we moved the discount rate in the next couple of days, we'd never go to $500 million.

MR. GUFFEY. This policy implies a 6-3/4 percent fed funds rate?

MR. JOHNSON. That is a good question. Nobody knows anymore.

CHAIRMAN VOLCKER. I happen to think it is a good thing that nobody knows. It could well be consistent with 6-3/4 percent, but how much money I would put on that--? I don't think it is necessary--

MR. ANGELL. It depends on what the expectations are about the discount rate.

CHAIRMAN VOLCKER. I guess what the staff says in the Bluebook is that it could even be below 6-3/4 percent.

MR. KOHN. What we had under alternative C, the $600 borrowing assumption, was a funds rate of something like 6-3/4 to 7 percent. So, with $500 million I would guess it would be around 6-3/4 percent.

CHAIRMAN VOLCKER. No. I am talking about with the discount rate change. With $500 million it might be a little less. But $600 million borrowing or the change in the discount rate with $400 million on borrowing are more or less equivalent.

MR. KOHN. That was 6-3/4 percent--or maybe a little higher, to 7 percent.

MR. MORRIS. There is also the question of how much the discount rate is raised, if it is raised.

CHAIRMAN VOLCKER. I am assuming we are talking about a half point, but obviously--

MR. MORRIS. Well, if the funds rate is at 6-3/4 percent, it seems to me a half point is a little [unintelligible]. Normally, one would expect a 6-1/4 percent discount rate. If we are doing it to get some impact on the foreign exchange market, which still makes sense to me, I think an increase above a half point might attract a little more attention. And it would certainly align the discount rate better with the funds rate than a move of a half point.

CHAIRMAN VOLCKER. Assuming the funds rate stays where it is.

MR. MORRIS. Yes, assuming it stays at 6-3/4 percent. That speaks for itself.

CHAIRMAN VOLCKER. But you're against moving the discount rate.

MR. MORRIS. Yes--only because I like to have something in the closet. Otherwise, the only alternative response is a still tighter monetary policy.

CHAIRMAN VOLCKER. I think that is the argument about the discount rate. Do you pre-empt or keep it in reserve?

MR. BLACK. That is what I would recommend to our Board on Thursday. But in the interest of Gramm-Rudmann, if the Board acts to approve a move on the discount rate before Thursday, we have to spend another $300 to get our executive committee together to go along with you.

CHAIRMAN VOLCKER. Well, I will discuss that too. I may save you $300.

MR. BLACK. There is going to be a bunch [of discount rate actions] coming in. There are more [boards of directors] that meet on this Thursday than at any other time.

CHAIRMAN VOLCKER. What we are talking about here is a kind of "modified C plus," or something--$500 million without a discount rate change, with the readiness, certainly, to go up to $600 million or so--

MR. GUFFEY. For what?

CHAIRMAN VOLCKER. If the exchange markets and inflation or whatever seem to justify it, and the business expansion wasn't falling out of bed, and the aggregates were more or less as expected, we would be quite ready to do that. But we wouldn't do that unless there were some reason for it. We could raise the discount rate; and we could do that today or tomorrow, in which case we'll stick with borrowing of around $400 million or so with some possibility of going above that if we need help later. If we start out at $500 million, we could shade it lower if we raise the discount rate later. But if we raise the discount rate later, under those circumstances, we'd probably have some reason for wanting to tighten up some or we wouldn't do it--unless it was part of some international agreement. [The likelihood of the latter] seems a little thin to me at this point, but in that case we might want to be totally neutral. We have two ways of tightening up as we proceed if we don't move on the discount rate immediately: either change the discount rate or change the borrowings a little, which is quite a normal situation. On those understandings, can we proceed?

MR. KEEHN. Would you read the wording as we now have it?

CHAIRMAN VOLCKER. "In the implementation of policy for the immediate future, the Committee seeks to increase somewhat the degree of reserve pressure sought in recent weeks, taking into account the possibility of a change in the discount rate. Somewhat greater reserve restraint would or somewhat lesser reserve restraint might be acceptable depending on indications of inflationary pressures and on developments in foreign exchange markets, as well as the behavior of the monetary aggregates and the strength of the business expansion." The rest of it is "6 percent or less," "below the pace during 1986," and "4 to 8 percent." Okay? What it means is that without changing the discount rate, the borrowing assumption is $500 million right now, the possibility of going up to $600 million is reasonably remote, and if we change the discount rate today or tomorrow the borrowing assumption is $400 million.

MR. JOHNSON. I do have a request. I agree with that completely. But I do think that we have to get a better understanding of this borrowing/funds rate relationship. I don't think it is acceptable that we continue on drifting, trying to figure out the relationship between borrowing and the funds rate if we are going to target borrowing as an approach to monetary policy. If we don't have some better understanding of the underlying funds rate associated with that, we've got to change because--

CHAIRMAN VOLCKER. Well, we can discuss that, because I disagree with that. I think it is a positive benefit almost--not getting driven into--

SPEAKER(?). That is what gets you into interest rate targeting.

CHAIRMAN VOLCKER. That's the problem.

MR. JOHNSON. If you don't understand it better.

MR. ANGELL. I don't want to see us get to interest rate targeting and I would favor--

MR. JOHNSON. Well, neither do I.

MR. ANGELL. I would favor the pegging of the nonborrowed, adjustment borrowings. But I would like to see us agree that we could sell coupons so that if we ever get into a situation like this again, we would thereby have enough coupons so as to let the markets know what our target was. If we have bought the coupons--

CHAIRMAN VOLCKER. Why do we want to buy bonds or sell bonds?

MR. ANGELL. I want to be able to buy bonds when there are not enough bills out there for repos.

MR. JOHNSON. What I am suggesting is that we still don't know if the discount window is going to act in an erratic fashion relative to what our intended policy is. I think that is an unacceptable degree of uncertainty. It has been a lot tighter than that in the past.

CHAIRMAN VOLCKER. It is only unacceptable if you are very sensitive to where the federal funds rate is--that this might be a mistake. That's what the argument is all about.

MR. JOHNSON. Well, I think there are times, obviously, when we are more sensitive to the funds rate. It varies. So, if we don't know what kind of funds rate is going to be associated with a certain amount of borrowing--. Am I right to say that that relationship has been much more stable in the past than it has been since the turn of the year?

MR. KOHN. Maybe than in the last couple of weeks. But it has always been unstable and difficult to determine. Even when we were on a nonborrowed reserve target, we used to have to take into account shifts in the borrowing function--certainly in 1984 when Continental was in [borrowing at the discount window]. There was considerable uncertainty then, too. So there has always been a bit of wiggle room in that.

MR. JOHNSON. Well, obviously, when there is special borrowing, you always--

CHAIRMAN VOLCKER. If you are really sensitive to where the federal funds rate is, the most efficient thing that you can do is target the federal funds rate.

MR. JOHNSON. The federal funds rate--

CHAIRMAN VOLCKER. Do you want to do that?

MR. ANGELL. No.

MR. JOHNSON. I am not sure I want to, but the relationship--

MR. ANGELL. You can decrease the uncertainty as to what the borrowing target is. What we've ended up with--

MR. JOHNSON. Okay, but there are studies--

VICE CHAIRMAN CORRIGAN. Oh, those studies are a lot of [unintelligible]. They average everything.

MR. ANGELL. We've ended up with a lot of participants and market watchers believing that our borrowing target is $500 to $600 million. It seems to me that it would be better to conduct policy in such a way that there would not be as much uncertainty as to what--

CHAIRMAN VOLCKER. Even that always exists. It is not unusual to miss these targets for several weeks. We had great big misses around the end of the year. Now people are more used to it around the end of the year, and they say: Okay, they are way off. Around the end of the year, we were way over a billion--

MR. JOHNSON. There are obviously special borrowing [situations] that come up. But, in the pattern of breaks that we have seen recently I don't think you can identify a special borrowing in each of those cases. The staff's response was that the demand for borrowing had shifted. That is something that I don't think we have a good understanding about.

MR. BOEHNE. The beauty of this nonborrowed target is that it allows for some ambivalence. You know you shouldn't be targeting the federal funds rate, but sometimes you would like to keep at least a broad eye on it. It makes for a nice kind of--

CHAIRMAN VOLCKER. I think we are getting diverted by this argument. I don't think we have voted yet, have we?

MR. ANGELL. We have not.

MR. JOHNSON. No.

CHAIRMAN VOLCKER. I think we better adopt a directive. This is a continuing saga, but let's get this vote out of the way.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Boehne	Yes
President Boykin	Yes
Governor Heller	Yes
Governor Johnson	Yes
President Keehn	Yes
Governor Seger	No
President Stern	Yes

MR. JOHNSON. I don't want to waste too much--

CHAIRMAN VOLCKER. It is a relevant question that comes up all the time, so maybe we should have a little paper on it for the next meeting.

MR. JOHNSON. I think there probably would still be a considerable debate at this table about which is more important to the conduct of monetary policy and which affects the economy more: levels of interest rates or the quantity of reserves.

CHAIRMAN VOLCKER. I don't know how big a discussion you want to have. We can have a great big discussion on operating techniques, but maybe we'll start it off, anyway, with a rather small paper on precisely [unintelligible]. [Laughter.] We will see whether that leads us into much deeper water, which it is very likely to do. I don't know if anybody is terribly happy about our current operating procedures. In fact, the weak [unintelligible] the money supply.

MR. JOHNSON. I know.

END OF MEETING